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August 26, 1997

BY HAND DELIVERY

Mr. William F. Caton
Office of the Secretary
Federal Communications Commission
1919 M Street, Room 222
Washington, D.C. 20554

Re: In the Matter of Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, CC Docket No. 96-128

Dear Mr. Caton:

Please find enclosed for filing an original and four copies of the Comments of the RBOC/GTE/SNET Payphone Coalition.

Please date-stamp and return the extra copy provided in the attached separate envelope.

Sincerely,

Michael K. Kellogg

Enclosures

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C.

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In the Matter of

Implementation of the Pay Telephone	)	
Reclassification and Compensation	)	CC Docket No. 96-128
Provisions of the	)	
Telecommunications Act of 1996	)	

COMMENTS OF THE
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TABLE OF CONTENTS

EXECUTIVE SUMMARY . . . iii

BACKGROUND . . . 1

A. The Commission's Orders . . . 1

B. The D.C. Circuit's Decision . . . 7

DISCUSSION . . . 11

I. THE PER-CALL COMPENSATION RATE [Remand Notice pp. 2-3] . . . 11

A. Examination of the Cost Differences Between Local Coin Calls on the One Hand and Subscriber 800 and Access Code Calls on the Other Shows That, Over-All, Local Coin Calls Have *Lower* Costs . . . 15

1. The Local Usage Charge . . . 15

2. Coin Counting and Collection Costs . . . 16

3. The Cost of Coin-Capable Payphones . . . 16

4. The Commission Must Add Any Costs Unique to Subscriber 800 and Access Code Calls . . . 17

5. The Total Net Avoided Cost Approach Requires Pricing Above the Local Coin Rate . . . 19

B. The Commission Also Must Adjust "Fair Compensation" Rates to Account for Differing Prices and Price Elasticities of Demand . . . 20

C. The Commission's Prior Analysis Confirms that Per-Call Compensation Must Be Set Above the Local Coin Rate . . . 24

D. The Commission Should Not Resort to Periodic, Full-Blown Cost Proceedings to Set Per-Call Compensation . . . 27

E. The Commission Must Set Per-Call Compensation Rates at Least $.07 Above the Competitive Coin Rate . . . 30

II. THE COMMISSION MUST IMPOSE A FULLY COMPENSATORY AND FAIR INTERIM COMPENSATION MECHANISM 32

A. Interim Compensation for 800 and Access Code Calls Must Be Fairly Calculated and Appropriately Allocated 32

1. The Interim Rate and Flat-Rate for Subscriber 800 and Access Code Calls Should Be Calculated Using the Same Methodology as Before 32

2. All Industry Participants Should Pay Their Fair Share of the Interim Compensation Obligation 34

B. The RBOCs and GTE Should Receive Appropriate Compensation for 0+ Calls During the Interim Period 35

C. The RBOCs and GTE Must Be Afforded Fair Interim Compensation for Inmate Payphones 37

D. The Commission May Make Retroactive Adjustments to Interim Compensation Levels 37

III. THE COMMISSION MUST VALUE LEC ASSETS AT NET BOOK VALUE 39

CONCLUSION 41

EXECUTIVE SUMMARY

As part of the "pro-competitive, de-regulatory national policy framework" of the Telecommunications Act of 1996, see S. Conf. Rep. No. 230, 104th Cong., 2d Sess. 1 (1996), Congress directed the Commission to revamp its regulatory treatment of the payphone industry. Among other things, Section 276 of the Act was designed "'to promote competition among payphone service providers,' by having the Commission 'establish a per call compensation plan to ensure that all payphone service providers are fairly compensated for each and every completed intrastate and interstate call using their payphone.'" Illinois Pub. Telecom. Ass'n v. FCC, No. 96-1394, slip op. at 5-6 (D.C. Cir. July 1, 1997) (internal citations omitted).

Consistent with those directions, the Commission moved boldly and swiftly to revamp its regulations. It deregulated the payphone market and local coin rate pricing; established a system of per-call compensation; and revamped the regulatory treatment of LEC payphones. Despite numerous petitions for review, the Court of Appeals for the District of Columbia Circuit largely upheld the new framework established by the Commission. Nonetheless, it remanded (and, with respect to asset valuation only, vacated) portions of the Commission's orders.

I. Eschewing artificial and unreliable cost-based regulatory approaches, the Commission set per-call compensation rates for subscriber 800 and access code calls by linking them to the competitively-established, deregulated local coin rate. In remanding this issue to the Commission, the Court of Appeals did not question the Commission's rationales for choosing a market-based, rather than a regulatory cost-based, approach. Instead, it questioned only the Commission's rationale for relying directly on the local calling rate as a proxy. Although the Commission stated that the costs of originating local coin calls and subscriber 800 and dial-around calls were similar, the Court of Appeals held that the Commission had failed to address evidence suggesting that the costs in fact were different. Illinois Pub. Telecom., slip op. at 15.

On remand, the Commission again must launch the payphone industry on its way to becoming a fully competitive market. As Congress and the Commission expressly concluded, competition, not regulation, is the best means of "promot[ing] the widespread deployment of payphone services to the benefit of the general public." 47 U.S.C. § 276(b)(1). Consistent with that goal, the Commission should establish per-call compensation rates that are commensurate with those that the market itself would establish. Because the market provides the best insight into that pricing, the Commission should begin with the local coin rate and, considering elasticity of demand and other factors the market would take into account, establish per-call compensation rates above the local coin rate.

As explained in the attached report of Arthur Andersen and declaration of Professor Jerry Hausman, examination of cost and other differences among call types shows that setting per-call compensation equal to the local coin rate undercompensates PSPs by approximately \$.07 to \$.08 per call. This undercompensation not only fails to meet Congress's mandate of "fair" compensation, 47 U.S.C. § 276(b)(1), but puts hundreds of thousands of payphones at risk in direct contravention of Congress's command to "promote widespread deployment" of public payphones for the benefit of the general public, 47 U.S.C. § 276(b).

A. In response to the Commission's request for information concerning cost differences, the Coalition has asked Arthur Andersen and Professor Hausman to perform avoided cost analysis. Examining the two costs that are allegedly avoided when subscriber 800 or access code calls are made -- coin handling costs and local usage charges -- they conclude that on average those costs amount to approximately \$.04 per call. For many PSPs, however, the avoided cost is far less -- as little as \$.01 per call. Thus, the maximum possible offset from the local coin rate is \$.04 per call, although a far lower figure could be justified.

This figure, moreover, does not take into account additional costs imposed with respect to subscriber 800 and access code calls. Andersen estimates that, if PSPs must pay LECs to send

ANI ii digits (and non-ANI ii identification will not be sufficient), the per-call cost of subscriber 800 and access code calls will be increased by as much as $.08 per call. Thus, the net avoided cost is on average *negative* $.04, and the Commission should -- if it uses an avoided cost methodology -- set per-call compensation at least $.04 *above* the prevailing price for a local call.

B. Relying on cost differences alone, however, would not be economically efficient because it fails to take into account demand conditions. As Professor Hausman explains in his declaration, a significant portion of total payphone costs -- such as the payset, the enclosure, and the payphone line -- are joint and common. Where significant portions of total costs are joint and common, efficient market (and hence efficient regulatory) pricing takes into account the different elasticities of demand for each product *as well as* differences in cost.

Once demand conditions are taken into account, "no reason exists to claim that the dial-around and subscriber 800 price should be less than the local coin call price" *even if* one assumes that subscriber 800 and access code calls cost less than local coin calls. Hausman Decl. ¶ 9. To the contrary, Professor Hausman has calculated that, once demand conditions are taken into account, the market would set per-call compensation at $.07 to $.08 *above* the local coin rate. Ibid. Failure to make this adjustment to account for demand differences will result in below market rates, a dramatic reduction in the number of payphones, and damage to social welfare. Id. ¶ 10. This would be precisely the opposite of what Congress intended when it required the Commission to "promote competition" in the payphone industry and to "promote the widespread deployment of payphone services to the benefit of the general public." 47 U.S.C. § 276(b)(1).

C. As a check against the above conclusions, the Coalition also has updated methodologies used by the Commission to set access code compensation rates (at $.40 per call) in 1992. Even with adjustments to account for the fact that subscriber 800 calls have a lower revenue potential than access code calls, these methodologies produce per-call compensation rates that are well above the local coin rate. For example, in 1992 the Commission relied in part on average AT&T commissions for 0+ payphone calls. An updated study, using commissions paid to large PSPs as a baseline, produces a per-call rate between $.43 and $.63 per call. If estimated AT&T commissions are used, the resulting per-call compensation rate to PSPs is between $.39 and $.57 per call.

D. Some carriers inevitably will demand that prices be set based upon average costs or some other regulatory costing measure rather than a market-based proxy. But competition would not price payphone calls at average cost; it would price them based on elasticity and other factors as well. Moreover, compensating PSPs only for their average costs would lead to the removal of payphones with above-average costs or below average volumes, even though competitive (and efficient) pricing would support them. Even a $.35 per-call compensation rate puts over 20 percent of all payphones at risk of removal, and each penny less than $.35 will result in the removal of thousands and thousands more. Rural areas will be particularly hard hit.

In addition, a cost-based formula would convert this competitive industry into a heavily regulated one. Non-LEC PSPs would have to keep regulated books; the Commission would have to monitor and review them; and the Commission and industry participants would be continuously embroiled in periodic updates to the regulatory per-call rate. This result cannot be reconciled with the promotion of competition through a deregulatory approach. Consequently, the Commission should continue on the course it charted out before, relying not on regulation but on competition -- such as by linking the per-call rate to a competitively-established proxy rate -- to ensure "fair" and fully compensatory results.

E. Thus, far from producing too much compensation, setting the per-call rate at the local coin rate results in too little. It is precisely such undercompensation that the Commission must avoid. To the extent the default rate set by the Commission is too generous, the market is fully capable of adjusting it downward through negotiations. As the Commission concluded and the Court of Appeals agreed, interexchange carriers can "block" calls from overpriced phones and thereby negotiate for a lower rate. See Recon. Order, 11 FCC Rcd at 21268-69, ¶ 71; Illinois Pub. Telecom., slip op. at 16. In contrast, because TOCSIA denies PSPs leverage with which to negotiate for a higher rate, market negotiations will not be able to increase the rate if the FCC fails to establish a fully compensatory default. Payphones will be removed, social welfare will be harmed, and the public will be inconvenienced. The Commission therefore must avoid establishing a sub-market rate that cannot be adjusted through market negotiations, and that will result in the removal of thousands of payphones in contravention of congressional command.

II. The Coalition believes that the Commission should establish interim compensation levels much as it did before. Once the Commission has established its methodology for per-call compensation, it should multiply the resulting estimated per-call rate by the average number of compensable calls per payphone per month. The Coalition also believes that LECs should pay their fair share of flat-rate, interim compensation, subject to the same limitations as IXCs.

As directed by the Court of Appeals, for RBOC and GTE payphones, the Commission also must provide interim compensation for 0+ and inmate calls. The Coalition agrees with the Commission's tentative conclusion that, since these are generally presubscribed calls, each carrier should be able to track and pay for them.

III. Finally, with respect to asset valuation, the Commission must use net-book value for all transfers of payphone assets to separate subsidiaries. As the Court of Appeals explained: "By adopting a going concern valuation methodology, the Commission was attempting to transfer [any] increase in the value of the payphone operations from the LECs (and their shareholders) to ratepayers. This was plainly inappropriate under Democratic Central." Illinois Pub. Telecom., slip op. at 26. Consequently, the Commission must value such assets at net-book value, as it has in similar CPE asset reclassification orders time and time again in the past.

BEFORE THE
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WASHINGTON, D.C.

In the Matter of		
Implementation of the Pay Telephone	)	
Reclassification and Compensation	)	CC Docket No. 96-128
Provisions of the	)	
Telecommunications Act of 1996	)	

COMMENTS OF THE RBOC/GTE/SNET PAYPHONE COALITION

Pursuant to the Public Notice issued by the Commission on August 5, 1997, the Bell Operating Companies ("BOCs") -- Ameritech, the Bell Atlantic telephone companies, BellSouth Corporation, Pacific Bell, Nevada Bell, Southwestern Bell Telephone Company, and U S WEST -- together with GTE Service Corporation ("GTE") and Southern New England Telephone Company ("SNET") (collectively, the "RBOC/GTE/SNET Payphone Coalition" or "Coalition") jointly submit these comments to address the issues identified in the Commission's August 5, 1997 Public Notice, DA 97-1673 ("Remand Notice"). To the greatest extent possible, these comments address the issues in the same order as the Remand Notice.

Background

A. The Commission's Orders

Implementing the Act's pro-competitive deregulatory framework, the Commission's Report and Order[1] and Reconsideration Order,[2] among other things, established a per-call compensation

[1] First Report and Order, Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, 11 FCC Rcd 20541 (1996) ("Report and Order").

[2] Order on Reconsideration, 11 FCC Rcd 21233 (1996) ("Recon. Order").

rate, identified the compensable calls, set up a system for interim compensation until true per-call compensation becomes feasible, and addressed the reallocation of LEC payphone assets from regulated to unregulated operations.

The Per-Call Compensation Requirement. As an initial matter, the Commission concluded that, absent indications of market failure, "the most appropriate way to ensure that PSPs receive fair compensation for each call is to let the market set the price for individual calls." Report and Order, 11 FCC Rcd at 20567, ¶ 49; Illinois Pub. Telecom., slip op. at 7. Noting that state price regulation often prevented PSPs from collecting fair compensation on local coin calls, the Commission required the gradual deregulation of the local coin rate. The local coin market, the Commission determined, was structured to operate competitively. Report and Order, 11 FCC Rcd at 20567, ¶ 50; Recon. Order, 11 FCC Rcd at 21258-59, ¶ 50. But as extra security, the Commission affirmed that it would intercede or allow states to intercede in the event of demonstrated market failure in the form of so-called "locational monopolies" or otherwise. Report and Order, 11 FCC Rcd at 20568, ¶ 51; Recon. Order, 11 FCC Rcd at 21258-59, ¶ 50.

At the same time, the Commission recognized that state price regulation, which often kept coin rates artificially low, was not the only regulatory barrier to "fair compensation" through market mechanisms. TOCSIA,[3] enacted by Congress in 1990, prohibited PSPs from blocking access code or "dial-around" calls to alternative carriers and thus, in effect, precluded them from demanding payment for the use of their phones in originating those calls. Report and Order, 11 FCC Rcd at 20567, ¶ 49. Because access codes are often 800 numbers, TOCSIA effectively prevented PSPs from blocking subscriber 800 calls as well. Id. at 20568, ¶ 52; Illinois Pub. Telecom., slip op. at 5. Accordingly, the Commission determined that it would have to intervene

[3] The Telephone Consumer Services Improvement Act ("TOCSIA"), Pub. L. No. 101-435, 104 Stat. 986 (1990) (codified at 47 U.S.C. § 226).

to provide "fair compensation" for access code and subscriber 800 calls. Report and Order, 11 FCC Rcd at 20568, ¶ 52; Recon. Order, 11 FCC Rcd at 21259, ¶ 51.

The Commission also determined that it was required to intercede with respect to 0+ calls made from RBOC and GTE payphones. Non-RBOC and non-GTE PSPs had, for many years, obtained compensation for 0+ calls originated on their phones. In particular, these PSPs would choose the presubscribed carrier for their phones in part based on the amount of compensation that would be paid to them. The RBOCs and GTE, however, had long been prohibited from selecting the presubscribed carrier on their payphones. Consequently, they could not negotiate for compensation on presubscribed calls. Report and Order, 11 FCC Rcd at 20569, ¶ 53; Illinois Pub. Telecom., slip op. at 4.

Although the Commission changed that imbalance in its order by allowing RBOC-affiliated PSPs to participate in carrier selection, many RBOC and GTE payphones were locked into long-term contracts with location owners. Because RBOCs and GTE will not receive compensation for presubscribed calls so long as those contracts are in force, the Commission determined that it would have to intervene to meet Section 276's requirement that fair compensation be paid for "each and every . . . call." Accordingly, it required carriers to pay compensation for presubscribed calls from RBOC payphones "so long as they do not otherwise receive compensation for use of their payphones in originating 0+ calls." Report and Order, 11 FCC Rcd at 20569, ¶ 53; Recon. Order, 11 FCC Rcd at 21259, ¶ 51.

The Amount of Per-Call Compensation. Although some parties had argued in favor of a single, nationwide "rate" based on an estimate of the cost of originating each type of phone call -- whether through TELRIC or some other cost-based standard -- the Commission rejected that approach. Any cost-based standard, the Commission explained, would have to rely on average costs because it would be impossible to calculate per-call costs for each of the nearly 2 million payphones in the country. Using average costs, however, would cause payphones with above-average costs (or below-average calling volumes) to be removed. The Commission therefore concluded that "a cost-based compensation standard could lead to a reduction in payphones by limiting a PSP's recovery of its costs, and this result would be at odds with the legislative purpose of Section 276 [to] 'promote the widespread deployment of payphone services to the benefit of the general public.'" Recon. Order, 11 FCC Rcd at 21267, ¶ 66.

Instead of relying on such a cost-based methodology, the Commission opted for a "market-based approach" that would accommodate the "likely cost variations" from "payphone to payphone." Recon. Order, 11 FCC Rcd at 21268-69, ¶ 71. In particular, the FCC decided that it would link the per-call compensation rate to the local coin rate. As the Court of Appeals later explained, the Commission gave only one reason for choosing the local coin rate as the appropriate "market-based" proxy for the access code and dial-around rate: Its conclusion that the costs of coin calls, 800 calls, and access code calls are all similar. Illinois Pub. Telecom., slip op. at 14.

Various parties objected to this linkage. Some argued (as they would later argue on appeal) that the Commission should have based its rate on the costs or marginal cost the PSP incurs in handling the call. See AT&T Petition for Reconsideration and Clarification, CC Docket 96-128 (filed Oct. 21, 1996), at 8-11; Joint Brief of Interexchange Carriers, Illinois Pub. Telecom. Ass'n v. FCC, No. 96-1394 (D.C. Cir. filed Feb. 14, 1997) ("Joint Brief of IXCs") at 35-36. Some argued (as they too would argue on appeal) that the local coin rate would be excessive because, even in a deregulated market, the local coin rate would be monopolistically set (on account of locational monopolies). See AT&T Petition for Reconsideration and Clarification at 10-12; Joint

Brief of IXCs at 26-32. Still others argued (as they again argued on appeal) that local coin calls cost PSPs more to handle than do subscriber 800 and access code calls. AT&T Petition for Reconsideration and Clarification at 9-10; Joint Brief of IXCs at 24.

At the same time, various LECs pointed out that the local coin rate provided too little compensation. In a competitive market, they argued, price and elasticity differences between local coin calls and the other call types would cause access code and subscriber 800 calls to be priced *higher* than the local coin rate. Accordingly, they argued that linking per-call compensation to the local coin rate resulted in too little compensation being paid. See Comments of the RBOC Payphone Coalition at 16-17, CC Docket 96-128 (filed July 1, 1997); Strategic Policy Research, Economic Report on FCC Resolution of Payphone Regulatory Issues at 34 (attached to the separate comments of BellSouth Corp., CC Docket 96-128 (filed July 1, 1997)) (hereinafter "SPR Report"); see also Brief for Respondents, Illinois Pub. Telecom. Ass'n v. FCC, No. 96-1394 (D.C. Cir. filed Apr. 18, 1977) at 57 ("FCC Br.").

Although it did not address the LECs' arguments that the linkage resulted in too little compensation, the Commission rejected all of the other arguments and adhered to its market-proxy principle. After explaining once again all of the reasons why the coin rate would be competitively set -- and promising to rectify the situation if it was not -- the Commission further explained that, in the unlikely event the rate had been set too high, the market could adjust it downward. Because the per-call compensation rate is only a default rate from which the parties may depart by negotiation, interexchange carriers can threaten to block calls originating on payphones (and can actually block such calls) to negotiate for a lower rate. Recon. Order, 11 FCC Rcd at 21242, ¶ 15.

Interim Compensation. Based on its conclusion that the local coin rate would be the appropriate measure for per-call compensation, the Commission also based its calculation of interim compensation -- flat-rate, per-line payments that would be made while the necessary per-call compensation software and mechanisms were being developed -- on the deregulated local coin rate. Because the local rate was $.35 per call in a majority of states with deregulated local phone rates, the Commission calculated the interim, flat-rate, per-line amount using $.35 per call. Report and Order, 11 FCC Rcd at 20578, ¶ 72. The Commission also determined that, for one year following the flat-rate period, per-call compensation would be set at $.35.

The Commission did not, however, provide any flat-rate or other compensation for 0+ calls made from RBOC and GTE payphones during the first part of the interim period, even though RBOC and GTE PSPs received no compensation for those calls. Illinois Pub. Telecom., slip op. at 18-19. Nor did it provide compensation for calls made from RBOC and GTE inmate payphones, even though RBOC and GTE PSPs likewise received no compensation for calls made from those phones. Recon. Order, 11 FCC Rcd at 21315, ¶ 180.

Asset Valuation. At the same time the Commission took the above steps with respect to per-call compensation, it also revamped its regulatory treatment of LEC payphone operations. Besides eliminating all federal and state payphone subsidies, the Commission reclassified payphones as deregulated CPE. Over the objections of the RBOCs, the Commission required those assets to be valued at "fair market value" if the assets were to be transferred to a separate affiliate. Recon. Order, 11 FCC Rcd at 21315, ¶ 179. This "fair market value," the Commission stated, was to include the value of intangible assets like location contracts, even if those intangibles never appeared on RBOC books. Over the objection of independent PSPs, the

Commission determined that, where assets were not transferred to a separate affiliate, they would be accounted for at net-book value. Id. at 21315, ¶ 180.

B. The D.C. Circuit's Decision.

Although virtually every aspect of the Commission's orders was challenged on appeal -- over 20 petitions for review were filed -- the Commission's decision was largely upheld. Indeed, of the multiple issues and arguments raised by the parties, only four issues have been remanded to the Commission.

The Per-Call Compensation Amount. Of the numerous challenges to the per-call compensation amount, the Court of Appeals accepted only one.

The Court began by rejecting a challenge to the Commission's decision to deregulate the local coin rate. Several state utility commissions and others argued to the Court that, under deregulation, prices for local coin calls would not be competitive; to the contrary, "locational monopolies" would produce monopolistic pricing. Echoing these same arguments, interexchange carriers attacked the linkage between local coin rates and the per-call compensation rate: Because the local coin rate would be inflated by monopolistic pricing, they vigorously argued, so too would the per-call compensation rate. Joint Brief of IXCs at 32 ("[T]he FCC's failure to consider the conceded monopolistic aspect of payphones in determining to use the local coin rate as the basis for its per-call compensation scheme renders its action arbitrary and capricious."); see generally id. at 26-33.

The Court rejected these arguments in no uncertain terms. It explained:

> The petitioners and intervenors failed to present any evidence that there are significant locational monopolies in states that have already deregulated their local coin rates; accordingly, it was not unreasonable for the Commission to conclude that market forces generally will keep prices at a reasonable level, thereby making locational monopolies the exception rather than the rule. If locational monopolies turn out to be

> a problem, however, the Commission suggested some ways in which it might deal with them . . . .

Illinois Pub. Telecom., slip op. at 12.

The interexchange carriers also argued vigorously that the Commission had failed to justify its rejection of TELRIC and other cost-based methodologies. Joint Brief of IXCs at 36 ("FCC acted arbitrarily and inconsistently with its other determinations in rejecting the IXCs' proposals for cost-based compensation and in finding deregulated coin rates to be a 'superior' surrogate."). The Court, however, found no fault with the Commission's rationales for rejecting any methodology that relies on average costs. Nor did the Court find fault with the Commission's decision to set a "default rate" using a "market surrogate."

The Court did, however, remand with respect to the Commission's rationale for the market-surrogate it selected. In particular, the Court read the Commission's orders as providing only "one ground" for linking the per-call compensation rate for subscriber 800 and access code calls to the price of coin calls -- "that the *costs*" of those calls "all are similar." Illinois Pub. Telecom., slip op. at 14. The Court went on to point out that the record contained evidence indicating that the costs in fact were not similar, and that the Commission had in no way addressed that evidence. Id.

Nonetheless, the Court agreed with the FCC that, in the event the default rate were inadvertently set too high, interexchange carriers could "block" calls from overpriced phones and thereby negotiate for a lower rate. See Recon. Order, 11 FCC Rcd at 21268-69, ¶ 71; Illinois Pub. Telecom., slip op. at 16. Despite the IXCs' "protest that they cannot currently recognize overpriced calls in 'real time,'" the Court explained, the IXCs "do not argue that they lack the technology to do so." The Court "therefore conclude[d] that the FCC's assumption that IXCs have the capacity to 'block' calls is reasonable." Id. at 15.

The IXCs' ability to negotiate for a lower rate by threatening to block calls, however, could not save the default rate. Even though the market could adjust by way of negotiation, the starting point -- the default rate -- had to be "reasonably justified." The Court therefore remanded the matter to the Commission for further consideration. Ibid.

Interim Compensation Levels. The Court determined that the same flaw which had required remand of the permanent per-call compensation rate also affected the interim rate. In establishing the rate for interim, flat-rate compensation, the Court explained, the Commission once again had relied on a linkage to the local coin rate. Because that linkage had not yet been justified, the Court concluded that the Commission would also have to reexamine the interim compensation amount on remand. Id. at 16-17.

The Court found two additional flaws with the Commission's calculation of interim compensation. First, despite the Commission's conclusion that RBOC and GTE PSPs were entitled to per-call compensation on 0+ calls, it had failed to count such calls toward the interim compensation obligation. "The Commission's failure to provide interim compensation for 0+ calls is patently inconsistent with § 276's command that fair compensation be provided for 'each and every completed . . . call.'" The Court therefore remanded so the FCC could "correct this flaw in the interim compensation scheme." Id. at 19.

Second, for similar reasons, the Court held that the Commission had failed to justify the exclusion of RBOC and GTE inmate payphones from the interim compensation mechanism. The Commission had reasoned that interim compensation was not necessary with respect to inmate lines because "such payphones are not capable of originating either access code or subscriber 800 calls." Recon. Order, 11 FCC Rcd at 21260, ¶ 52. The Commission, however, failed to explain why RBOC and GTE inmate payphones should not be eligible for interim compensation based on their carriage of 0+ calls. The Commission, after all, had concluded that the RBOCs and GTE should receive per-call compensation for such calls so long as they were "not otherwise receiv[ing] compensation for them." See Illinois Pub. Telecom., slip op. at 19-20.

Allocation of Interim Compensation Obligations. In addition to remanding the Commission's calculation of the interim compensation amount, the Court also declined -- for two, distinct reasons -- to accept the Commission's allocation of interim compensation obligations among carriers.

First, in allocating the interim compensation obligation, the Commission had imposed the obligation only on larger carriers. Report and Order, 11 FCC Rcd at 20601, ¶ 119. The Court, however, concluded that "[a]dministrative convenience cannot possibly justify an interim plan that exempts all but large IXCs from paying for the costs of services received." Illinois Pub. Telecom., slip op. at 17.

Second, the Commission had allocated the interim compensation obligation in proportion to total toll revenues. Report and Order, 11 FCC Rcd at 20601, ¶ 119. The Court, however, did not believe that such an allocation was appropriate. The Commission, the Court stated, had "not establish[ed] a nexus between total toll revenues and the number of payphone-originated calls." Illinois Pub. Telecom., slip op. at 17. Accordingly, the Court remanded those issues for further consideration. Ibid.

Asset Valuation. Finally, the Court turned to mirror-image appeals from the FCC's decision concerning the valuation of LEC assets reallocated from regulated to unregulated operations. Under Democratic Central Committee v. Washington Metro. Area Transit Comm'n, 485 F.2d 786, 805-08 (D.C. Cir. 1973), the Court held that the "party that bore the risk of loss is the party entitled to the capital gains on the assets." Illinois Pub. Telecom., slip op. at 25. Since the shift to price cap regulation, the Court explained, "the ratepayers no longer b[ear] the risk of losses from payphone operation assets." Id. at 27. Because "investors rather than ratepayers have borne the risk of loss on payphone assets (tangible and intangible)," the Court held that, "under Democratic Central, investors should reap the benefit of increases in the value of such assets." Ibid.

The Commission's decision to require fair market valuation, the Court held, was inconsistent with this rule. "By adopting a going concern valuation methodology, the Commission was attempting to transfer the increase in the value of the payphone operations from the LECs (and their shareholders) to ratepayers." Id. at 26. Because this "was plainly inappropriate under Democratic Central," id., the Court vacated and remanded that portion of the order, id. at 28. For identical reasons, the Court rejected a challenge to the Commission's treatment of assets not transferred to a separate subsidiary. Because the shareholders bore the risk of loss on those assets, the Court concluded that the Commission did not err in allowing those assets to be reallocated at net-book value. Id.

DISCUSSION

In its Remand Notice, the Commission sought comment on the default rate for compensation of subscriber 800 and access code calls, the interim compensation plan, and asset valuation. These comments address each of these issues in turn.

I. THE PER-CALL COMPENSATION RATE [Remand Notice pp. 2-3]

In setting the rate for per-call compensation, the Commission's prior orders followed a fundamental principle nowhere disputed by the Court of Appeals -- that the market price is not only the efficient (and therefore socially desirable) price, but the "fair" price as well. Notice of Proposed Rulemaking, Implementation of the Pay Telephone Reclassification and Compensation

Provisions of the Telecommunications Act of 1996, 11 FCC Rcd 6716, 6726, ¶ 16 & n.54 (1996) ("NPRM"); Report and Order, 11 FCC Rcd at 20567, ¶ 49; Illinois Pub. Telecom., slip op. at 7 ("the best way of ensuring that PSPs are 'fairly compensated' is to let the competitive market set the price for each call."). Indeed, despite rigorous challenges on appeal, the D.C. Circuit affirmed this bedrock principle. Rejecting various challenges to the Commission's decision to allow the market to set the rate for local coin calls, the Court concluded that the Commission's "market-based approach" would provide "fair" rather than excessive compensation for local coin calls. See Illinois Pub. Telecom., slip op. at 12 (rejecting claims that the resulting compensation would be excessive); id. at 13 ("A market-based approach is as much a compensation scheme as a rate-setting approach.").

Consistent with this fundamental conclusion, the Commission's payphone orders attempted to move away from artificial, regulatory constructs even in those areas where the Commission was, because of legislative or judicial intervention, required to establish a compensation system. Instead, the Commission looked to competitive market transactions for guidance. Thus, when the Commission intervened to establish compensation for subscriber 800 and access code calls (because TOCSIA had precluded the market from functioning), the Commission eschewed abstract and inherently arbitrary measures of costs. Instead, it turned to actual market experience and market prices for similar services.

These same principles -- adherence to market rates and market examples wherever possible -- should govern the Commission's inquiry on remand. Nowhere in its opinion did the Court disagree with or even question the Commission's decision to favor "market-based" over cost-based rates. To the contrary, despite the interexchange carriers' broad-based attack and claims that abandonment of cost-based pricing had not been justified, see Joint Brief of IXCs at 36, the

Court faulted the Commission in only one respect -- for failing to recognize potentially important differences between the service being used as a proxy (local coin calls), and the service for which compensation was being set (subscriber 800 and access code calls). In particular, the Court expressed concern that the Commission might not have properly addressed cost differences between the coin calls (that were providing the price proxy) and dial-around and subscriber 800 calls (for which the price proxy was to be applied).

The Commission accordingly decided to seek comment on "differences in costs to the PSP of originating subscriber 800 calls and access code calls, on the one hand, and local coin calls, on the other hand," as well as the extent to which the difference, if any, should "affect a market-based compensation amount." Remand Notice at 2. These comments address the inquiry in four parts.

First, in Part I-A below, the Coalition analyzes the results of using a net avoided cost methodology. Under this methodology, the price of access-code and subscriber 800 calls is set equal to the local coin rate, with an adjustment to account for any costs that are "avoided" (or imposed) because the call is a subscriber 800 or dial-around call. This methodology, it turns out, supports a per-call compensation rate that *exceeds* the competitively-determined, prevailing local coin rate. Subtracting avoided costs from the local coin rate reduces the per-call rate for many PSPs by as little as $.01 or $.02 per call. Adding in additional costs *imposed* as a consequence of per-call compensation, however, increases the per-call rate substantially -- by as much as $.08 per call. See Part I-A, infra.

In any event, adjusting for cost-differences alone does not yield the appropriate "market" or "fair" compensation rate. Accordingly, in Part I-B below, the Coalition discusses additional adjustments that must be made to ensure that the per-call price properly mimics efficient market outcomes. As Professor Hausman explains, once these differences (primarily differences in demand for different call types) are accounted for, it is clear that the market would price access code calls and subscriber 800 calls above the competitive local coin rate. Indeed, he estimates that the competitive market would price such calls $.07 or $.08 higher than the prevailing local coin rate. Hausman Decl. ¶ 28, 42. Moreover, as demonstrated in Part I-C below, an alternative methodology used by the Commission to set per-call compensation in 1992 (after adjustment to account for any differences between subscriber 800 and access code calls) confirms this result. Because the market would price access code and subscriber 800 calls at a rate that exceeds the local coin rate -- and because such pricing is efficient -- the Commission should do likewise.

Finally, it is inevitable that some carriers will urge the Commission to change its approach entirely and base prices on a regulatory-accounting model or some other cost-based approach -- even though the Court of Appeals had no issue with the Commission's use of a market-based methodology. A cost-based approach not only embroils the Commission in highly uncertain, expensive, and hotly contested cost-calculation proceedings at regular intervals, but inevitably will produce results that are flatly inconsistent with Section 276. As the Commission previously determined, any cost-based standard would have to rely on average costs, and reliance on average costs would cause the removal of thousands of payphones with above-average costs (or below-average calling volumes). The Commission therefore was entirely correct to conclude that "a cost-based compensation standard could lead to a reduction in payphones by limiting a PSP's recovery of its costs, and this result would be at odds with the legislative purpose of Section 276 [to] 'promote the widespread deployment of payphone services to the benefit of the general public.'" Recon. Order, 11 FCC Rcd at 21267, ¶ 66. There is no reason to reconsider that conclusion here.

A. Examination of the Cost Differences Between Local Coin Calls on the One Hand and Subscriber 800 and Access Code Calls on the Other Shows That, Over-All, Local Coin Calls Have *Lower* Costs

The Commission's remand notice first requests comments on cost differences to PSPs of "subscriber 800 calls and access code calls, on the one hand, and local coin calls, on the other hand." Remand Notice at 2. One way to analyze these cost differences is through an avoided cost methodology. As explained below, an avoided cost methodology alone will not yield an appropriate result. See pp. 20-24 infra. However, because the Commission has asked for comments on cost differences, the Coalition addresses avoided costs first.

According to the Court of Appeals, the interexchange carriers identified just two ways in which the costs of carrying local coin calls might differ from the costs of dial-around and subscriber 800 calls. First, the costs of local coin calls might be higher "because the PSP bears the costs of originating *and* completing the local calls (*i.e.*, the 'end-to-end costs'); by contrast, for coinless calls, the PSP only bears the costs of *originating* the calls." Illinois Pub. Telecom., slip op. at 14. In other words, PSPs may incur a local usage charge on local coin calls, whereas they do not incur such a charge for subscriber 800 and access code calls. Second, local coin calls impose the costs of collecting, counting, and handling coins; dial-around and subscriber 800 calls do not. Ibid. We address each of these supposed cost differences in turn.

1. The Local Usage Charge

The first argument championed by the interexchange carriers on appeal -- that dial-around and subscriber 800 calls are less expensive because the PSP does not incur a local usage charge -- assumes that PSPs in fact always incur a "measured" charge on local coin calls. This is not true. With respect to many lines in many regions, no such charge is imposed. Report of Arthur Andersen on Per-Call Compensation and Cost Calculations at 3 ("Andersen Report"). Where payphone lines are "flat rated," PSPs do not incur "termination" or "local usage" charges, whether the call is local coin, dial-around, or subscriber 800. Ibid.

Thus, for carriers using flat-rated lines, the effect of any local usage adjustment is nil. Indeed, as Andersen explains, of the eight companies making up the Coalition, six use flat-rated lines. Consequently, the Commission should not impose any offset for local usage charges. If the Commission were to impose such an offset nonetheless, the maximum offset would be $.02, the average local termination cost across all Coalition members. See Andersen Report at 3.

2. Coin Counting and Collection Costs

The second potential difference identified by the Court is the cost of coin collection, counting, and related equipment. On average, coin collection and counting costs account for approximately two cents of the total cost of a local coin call. Andersen Report at 4. Even this figure may well be somewhat inflated, as it allocates coin collection costs among coin calls -- local and non-local -- based on call volumes rather than on the number of coins deposited. Id.

3. The Cost of Coin-Capable Payphones

Apparently aware that these purported cost differences cannot justify the confiscatory rates they seek, the interexchange carriers have argued that it is improper to allocate a pro-rata share of equipment costs to dial-around and access code calls. This, they have argued, is improper since coinless equipment is cheaper than equipment capable of handling coins, and dial-around and access code calls could be made from coinless phones.

Setting aside (for the moment) the fact that the carriers have grossly understated the cost of providing a competent coinless phone, see Andersen Report at 7-8, the argument fails as a matter of basic economic theory. As Professor Hausman and Arthur Andersen both explain, most payphones could not be supported unless they were capable of handling coin calls. Hausman